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The January 4 Federal Reserve Chairs Joint Interview panel at the largest and most prestigious economics conference in the country was a standing room only affair with a massive media presence. I got there fifteen minutes early and almost did not get a seat. New York Times senior economics correspondent Neil Irwin provided an early joke about current Chair Jerome Powell not being an economist, then proceeded to ask Chair Powell and former chairs Janet Yellen and Ben Bernanke a variety of questions about monetary policy.

Readers of CERF blogs and forecast publications know that CERF economists are critical of the Fed's monetary policy, and have been for seven years now. The Fed's policies starting in December of 2008 were extraordinary, unprecedented, not recommended by economic theory, and have contributed to anemic growth and wealth generation for the past decade.

Prior to December of 2008, the Fed mainly relied on one policy tool, the Federal Funds Target rate (FFRT). During the dark days of the financial crisis, they added two more policy tools, quantitative easing (QE) and interest on reserves (IOR). CERF is most critical of IOR.

There are a few things that economists agree on, and one of them is that financial intermediation is good for the economy. This is the process by which banks use savings deposits as a pool of funds to extend credit to businesses and households. The IOR reduces the quantity of loanable funds available for intermediation by taking them out of the banking system and locking them up as reserves at the Fed. Lending falls, investment expenditures fall, growth slows, and capital accumulation and future wealth fall. These are unmistakably bad economic outcomes compared with having those funds available and extended to households and businesses who are growing.

What's more, it is not clear how the Fed would respond if there were a severe recession tomorrow. If they raised IOR, this would further restrict credit. They could reduce IOR, but in a severe recession, weak loan demand would make this less effective.

It is clear that the Fed wants to maintain a massive balance sheet, and they have documented various technical benefits. However, it is fearful of rapidly unwinding it, and this is the real reason for the glacial reduction pace. A consequence of the Fed's massive balance sheet is that it destroys the Fed's ability to control short term interest rates. IOR, a rate that the Fed sets directly, provides the short term interest control they desire. The interest rate on reserves may actually be the most impactful policy that the Fed is employing, but that is only because unwinding the balance sheet would wreak unknown but horrible damage to the economy.

CERF economists have also criticized the fact that the Fed's policy statements highlight the FFRT and QE, but IOR information is no longer provided in the Fed's main press release. Since December of 2015, changes to IOR have been deliberately buried in a technical note separate from the press release.

At the panel, Chair Powell and former chair Bernanke stressed the Fed's goal of being transparent. They repeated their desire to clearly and frequently communicate their policy intentions to the world. However, not one word was uttered about IOR at any point during the one-hour long discussion on Monetary Policy. It was clear this was done on purpose. Neither the press nor the economics profession have properly brought the IOR policy and the resulting economic detriment to light until recently. In particular, the January 1<sup>st</sup> Wall Street Journal article, *The Fed's Obama-era Hangover* by Phil Gramm and Thomas Saving, highlights the powerful impact of IOR on credit. The article also explains that the Fed is now an interest rate follower. It is no longer setting or leading short term rates.

It is clear that the Fed's stated transparency goal is contradicted by the reality of the Fed's actions.

I have a theory to explain this contradiction. As forecasters, CERF economists routinely promulgate their economic analysis and their forecasts to the press and the

community. This is a challenge. Economics is a complicated undertaking. There are subtleties and complexities. It happens that we'll interview with the Media and then read their article and wonder what went wrong because the written article misrepresents our views and/or our analysis. This appears to be a reality of the interface between economists and non-economists.

We have tools to deal with this issue. We tell stories as much as possible. We try to pull back from talking about many relevant factors to focus on one key factor. But these strategies do not always work.

It may be that the Fed does not talk about IOR because it is difficult to explain. There is more to IOR than the financial intermediation impact, as the Gramm and Saving article reveals. The complexities include IOR interaction with other policy tools and various aspects of the economy. It is difficult to explain to the public, in fact, even to economists who do not follow monetary policy closely. Perhaps more important, the Fed does not want to publicly admit they are deeply fearful of the impact of rapidly unwinding the balance sheet. Chair Powell would loathe to discuss either the difficulties with unwinding the balance sheet, or the IOR's impact on the economy in public.

The Fed needs to come clean. The Gramm-Saving article is likely to generate greater commentary, more articles, and additional questions directed to the Fed about its IOR policy and its assessment of the impact of IOR on the economy. I expect that the pressure will become large enough that the Fed will be forced to directly address its IOR policy to the public.

With greater Fed transparency in IOR, academic researchers should then contribute. They can build theoretical models of monetary policy that postulate and analyze formulae linking IOR to reserve flows, lending, investment, economic growth, and capital formation. Empirical papers should then be written that test and use these new theories, and in particular, they should measure the detriment that IOR has on financial intermediation, economic growth, and wealth formation.

As we await greater scrutiny of Fed policy, it is becoming increasingly clear to the CERF team that the Fed doesn't know how to undo the mess it created during the financial crisis. The need to maintain its massive balance sheet necessitates ever higher IOR. It places the Fed in the position of following market interest rates rather than driving them, as highlighted by Gramm and Saving. It jeopardizes the Fed's activist mandate and renders it impotent if a severe recession were to occur tomorrow. This is such a mess that we should assume the next economic contraction could be at least as bad as the last one that the Fed seeded.

Gramm P. and T. Saving, *The Fed's Obama-Era Hangover*, The Wall Street Journal, Jan. 1, 2019 <https://www.wsj.com/articles/the-feds-obama-era-hangover-11546374393?mod=mhp>